

Summary of CFTC Position Limit Proposal for Exchange Energy Markets

WHAT DOES IT MEAN FOR ME?

The Commodity Futures Trading Commission (CFTC) has issued a proposed rule-making for public comment (the Proposal) that would establish a new structure of Federally set position limits across all contract months in exchange-traded contracts in certain identified energy commodities. The CFTC Proposal is limited by the scope of the CFTC's existing jurisdictional authority. Of primary concern is that virtually all over-the-counter (OTC) contracts, including Exempt Commercial Market (ECM) contracts that are not designated by the CFTC as Significant Price Discovery Contracts (SPDCs), would be excluded from the limits. Foreign boards of trade also fall outside the scope of the rule making. This heightens our concern (also expressed by some of the CFTC Commissioners) that the imposition of position limits in the highly regulated exchange space will, contrary to the current trend of encouraging exchange trading and enhanced transparency, cause market users to seek out less restrictive and less transparent venues.

The comment period will close on April 26, 2010. We hope that this summary will inform your analysis of the Proposal and highlight certain potential issues that we have identified. Please let us know if we can provide any further guidance or assistance in your assessment of the proposal or in preparing a comment letter for submission.

What types of limits is the CFTC proposing?

The CFTC is proposing to impose new Federal all-months-combined, single-month, and spot-month speculative position limits for contracts based on an identified set of energy commodities. The limits are established using a formula based on open interest. The proposed Federal speculative position limits on energy contracts would be in addition to, and not a substitute for, an exchange's existing speculative position limit and accountability requirements.

What contracts will be covered by the proposed limits?

The CFTC Proposal defines four "Referenced Markets" subject to position limits:

- i) Crude Oil based on the physical delivery described in NYMEX's rules;
- ii) Heating Oil based on the physical delivery described in NYMEX's rules;
- iii) RBOB Gasoline Blendstock based on the physical delivery described in NYMEX's rules; and
- iv) Natural Gas based on the physical delivery described in NYMEX's rules.

Within each referenced market, the CFTC Proposal then establishes three classes of contracts: physically settled, financially settled on a designated contract market (DCM) and SPDCs traded on ECMs.

What contracts are not covered by the proposed limits?

The scope of referenced energy contracts subject to the position limits does not include basis contracts, which are contracts that are cash-settled based on the difference in price of the same or substantially same commodity at different delivery points. Also excluded are diversified commodity index futures that are based on such contracts' commodities. Diversified commodity indexes are defined as commodity indexes that are comprised of contracts in energy as well as non-energy commodities.

How are the position limits calculated in the proposal?

The total open interest used to calculate the limits will be based on the average of the month-end open interest across all classes of applicable futures and options contracts for the prior calendar year. Open interest in crack and calendar spreads will not be included in the base as they do not, according to the CFTC, represent outright exposure. However, although excluded from the base used to set the aggregate all-months-combined and single-month position limits, spread positions would still be attributable to traders for the purposes of determining a trader's compliance with speculative position limits.

How will the limits be applied?

As described above, the proposal establishes three classes of contracts within each Referenced Market: physically settled, financially settled on a designated contract market (DCM) and SPDCs traded on ECMs. Under the Proposal, an exchange would monitor its markets for position limit compliance within a particular class, and the CFTC would monitor aggregate compliance with the limits across classes and across reporting markets. Positions across classes would be netted; however, no position in any one class can exceed the aggregate limit. Thus, in any one class, notwithstanding positions held by a participant in other classes, that participant could hold no more than the maximum position limit for that particular class.

How are the any-one month and all months combined limits established?

Aggregate any one month and all months combined limits will be set across the three classes of contracts within each Referenced Market without regard for the particular exchange on which the product trades. The CFTC will establish the all-months-combined aggregate limit based upon the following formula: 10 percent of the first 25,000 in open interest and 2.5 percent marginally on an annual basis thereafter. The single-month aggregate limit will be set at two-thirds of the all-months limit.

How will the spot month limits be determined?

The Proposal would establish spot month position limits on a per class basis. Unlike any one month or all months limits, spot month limits are not aggregated either across classes or across exchanges.

- 1) Physically Settled Contracts. With respect to physically delivered contracts, the CFTC would utilize the existing standard of 25 percent of deliverable supply (rounded up to the next even 100 contracts).
- 2) Cash-Settled Contracts. For cash-settled contracts based on the prices of physically-delivered futures contracts, the Proposal would establish a default spot-month position limit equal to that of the physically-delivered counterpart.

The Proposal would also establish a conditional limit whereby a trader could hold positions in a cash-settled spot-month class of contracts that is five times the default spot-month limit upon satisfying the following conditions:

- The trader does not hold a position in any physically-delivered referenced energy contract to which its cash-settled positions are linked in the spot month.
- A trader would need to file certain data with the exchange during the expiration or spot month period.

Does the proposal require concentration limits, such as the concentration limits that are currently maintained by the exchange?

The Proposal does not include a formal structure to address a concentration maintained by a particular entity within the position limits. However, the CFTC indicated that under core principles, it would continue to endorse some form of accountability that would require individual exchanges to monitor markets to properly deal with concentration issues.

Will Foreign Boards of Trade be subject to position limits?

Foreign boards of trades are not subject to the Proposal; however, under the existing no-action regime, foreign boards of trade would be subject to limits comparable to those applicable to the relevant Referenced Market in order to be eligible to operate in the United States as a FBOT; however, they would not be included in the cross-market aggregation of positions.

How will new contracts be treated?

With regard to new contracts in Referenced Markets established by either a new or an existing exchange, the Proposal would establish a minimum position limit for a reporting market of 5,000 contracts in any one month or 1 percent of the aggregated open interest value (whichever is greater) and approximately 30 percent more contracts (i.e., 6,500) in all months combined. When the new contract reaches a certain level of open interest, the contract would be included in the aggregate limit structure.

Under what circumstances will hedge exemptions be granted?

The circumstances under which exemptions will be granted will be much more restrictive than under the existing regime. Under the Proposal, exemptions would be available for bona fide commercial hedgers with physical exposure and swaps dealers qualifying under a newly created financial “risk management” exemption. However, with limited exception, market participants who hold positions pursuant to a hedge exemption are precluded from holding any speculative positions.

The commercial and swap dealer exemptions are not handled equivalently. A commercial participant has no restriction per se as to the size of the exemption; however, any entity that receives a hedge exemption on a single-month or all-months basis in excess of two times the position limit would be prohibited from holding any open positions as a swap dealer. On the other hand, swap dealers operating under the exemption are limited to two times the position limit (on a single-month or all-months-combined basis) and exemptions are not permitted in the spot month.

The CFTC’s Proposal does not allow for any exemptions for index funds.

How will account positions be aggregated under the proposal?

The Proposal would establish account aggregation standards specific to positions in Referenced Markets. Under the Proposal, the Federal position limits in Referenced Markets would apply to all positions in accounts in which any person, directly or indirectly, has an ownership or equity interest of 10 percent or greater or, by power of attorney or otherwise, controls trading. As is the case today for Federal position limits in enumerated agricultural commodities, the Proposal would aggregate positions in accounts at both the account owner and controller levels. However, the Proposal does not provide for the independent controller exemption from such aggregation that is available for the enumerated agricultural commodities.

What are the major issues raised by this proposal?

There are a number of potentially significant concerns that have been raised about the Proposal. We have highlighted below a few that could impact CME Group and you, its customers.

General. From a general perspective, the CFTC’s Proposal would establish a new and arguably complex system of multiple layers of restrictions on positions in exchange-traded futures and SPDCs. Additionally, this proposal may have a significant impact on your current business models and lines of business. For example, an entity that engages in both trading in the physical cash commodity and in trading as a swap dealer and that applies for a bona fide hedge exemption to hedge its physical activity generally would thus be crowded out from engaging in any speculative trading or in obtaining a separate risk exemption to hedge its swap activity. You should also consider the systems changes and other costs that may be incurred in order to monitor compliance with the multiple sets of limits that are proposed.

Increase in less transparent trading. There is currently pending legislation that seeks to expand the scope of the CFTC’s authority over the OTC market and some non-U.S. boards of trade. In the absence of such legislation, however, it is likely that the limits could result in trading moving from open, transparent markets to the less transparent OTC market or non-U.S. trading venues.

Conditional Limits and Impairment of the Price Discovery Function. The proposed conditional limits in the spot month for financially settled contracts could impair the efficiency and effectiveness of the market's price discovery function. If market participants utilize the conditional limit, they would be prohibited from trading in the physical contract. This could cause a shift of volume and open interest away from the physically settled futures contract. Consequently, value of the price discovery mechanism provided by the physical contract would be diminished.

An example of this scenario is where a swap dealer who traditionally maintained positions in the spot month of the physical hedging its financial exposure wishes to avail itself of the larger conditional limit. Such dealer then cannot trade the underlying physically settled futures market and the traditional role the dealer would play in price discovery and liquidity for the physical contract would be compromised. This would adversely affect all market participants. This may also result in wider and more volatile expirations. As a result, there is significant concern that the central price discovery function served by regulated markets could be undermined.

Impact on Entities with Integrated Operations. As a result of the proposed exemption process, the proposal could have a significant impact on existing business operations. The proposed structure runs contrary to the established use of these markets for hedging of integrated exposure and speculation. This, in turn, could have chilling effect on business brought to the exchange and may result in business moving to other non-CFTC regulated markets, which, in turn, may make our markets less efficient and transparent.

The Proposal defines swap dealers so that an entity is either a swap dealer or hedger, but cannot be in both categories if they are operating pursuant to a hedge exemption. In addition, the breadth of the definition will capture some traditional commercial hedgers. Thus, by being placed in just one of these exclusive categories, a market participant will likely find that not all of its activity is eligible to be treated by the exemption. The rationale for restricting a large commercial hedger with respect to its ability to hold open positions as a swap dealer is unclear. Entities with integrated commercial and swap dealing operations should consider how this will impact them. The CFTC Proposal would limit or cap swap dealer exemptions to two times the position limit (on a single-month or all-months-combined basis) and as noted broadly defines swap dealers in a manner that will capture some traditional commercial hedgers. As a result, this aspect of the Proposal could provide a new rationale for shifting activity away from transparent markets regulated by the CFTC.

Aggregation of Ownership. Eligible entities (such as mutual funds, commodity pool operators (CPOs) and commodity trading advisors (CTAs)) and futures commission merchants (FCMs) will not be permitted to disaggregate positions pursuant to the independent account controller framework established in part 150 of the Commission's regulations for agricultural commodities. Thus, notwithstanding the independence of traders and business units, these entities now become more likely to exceed the limits and may need to restrict their current activity. Also, as a result of being bundled together, it becomes more likely that the firms would be confronted with the consequences of the crowding-out provisions.

Absence of Exemption for Index Funds and ETFs. Because of the absence of exemptions for index funds and exchange traded fund customers, such entities would need to establish any significant derivatives exposure indirectly through swap dealers or restructure its fund to decrease its reliance on U.S. commodities and shift to non-U.S. products.

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If you have any questions regarding the Proposal or CME Group's perspective, please contact Tom LaSala, Managing Director and Chief Regulatory Officer, at (212) 299-2897, or at thomas.lasala@cmegroup.com; or Brian Regan, Managing Director, Regulatory Counsel at (212) 299-2207, or at brian.regan@cmegroup.com.